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No. 80/101

June 26, 1980

TO COUNTY ASSESSORS:

ATTORNEY GENERAL OPINION NO. 80-322

For your information we are forwarding a copy of Attorney General Opinion No. 80-322, June 18, 1980. It is the opinion of the Attorney General that the provision of Board Rule 468 that permits a reassessment of oil and gas rights based on an increase in the recoverable amounts of oil and gas caused by a change in economic conditions is unconstitutional.

Sincerely,

Verne Walton, Chief
Assessment Standards Division

VW:sk
Enclosure

TO BE PUBLISHED IN THE OFFICIAL REPORTS

OFFICE OF THE ATTORNEY GENERAL
State of California

GEORGE DEUKMEJIAN
Attorney General

RECEIVED

JUN 25 1980

Division of Assessment Standards
SACRAMENTO

OPINION	:	No. 80-322
	:	
OF	:	JUNE 18, 1980
	:	
GEORGE DEUKMEJIAN	:	
Attorney General	:	
	:	
WARREN J. ABBOTT	:	
Assistant Attorney General	:	
	:	

The HONORABLE DON ROGERS, ASSEMBLYMAN,
THIRTY-THIRD DISTRICT has requested an opinion on the
following question:

Does a reassessment of oil and gas rights based
on an increase in recoverable amounts of oil and gas
caused by a change in economic conditions violate
Article XIII A of the California Constitution?

CONCLUSION

A reassessment of oil and gas rights based solely
on an increase in recoverable amounts of oil and gas
caused by a change in economic conditions violates Article
XIII A of the California Constitution.

ANALYSIS

With advent of the decontrol of oil prices by the
federal government and the consequent increase in crude
oil prices in California, many oil field operators are
finding that they can now economically recover more oil
from a given tract than previously estimated. This is
particularly true in areas of the San Joaquin Valley where
increased prices now make the use of secondary and
tertiary recovery techniques economically feasible to
extract heavy crude oil. As a consequence, the rights
possessed by the oil operators are more valuable. The
question presented is whether the county assessors may
reappraise those oil interests and reassess them solely
because of the increase in estimated recoverable oil reserves
brought about by the change in economic conditions, that

is, the increase in crude oil prices in the market. We conclude that the reassessment restrictions contained in section 2 of Article XIII A of the California Constitution added by an initiative measure in June 1978 preclude such a reassessment.

Section 1 of Article XIII provides in part:

"Unless otherwise provided by this Constitution or the laws of the United States:

"(a) All property is taxable and shall be assessed at the same percentage of fair market value. . . . The value to which the percentage is applied, whether it be the fair market value or not, shall be known for property tax purposes as the full value.

"(b) All property so assessed shall be taxed in proportion to its full value."

Pursuant to this constitutional directive the Legislature has defined "property" to include ". . . all matters and things, real, personal, and mixed, capable of private ownership." (Rev. & Tax. Code, § 103.)^{1/} In turn, real property is defined to include:

"(b) All mines, minerals, and quarries in the land, . . . and all rights and privileges appertaining thereto." (§ 104 (b).)

Also, in the article dealing with the preparation and contents of the assessment roll (§ 601 et seq.), the Legislature has provided:

"In the event that a separate assessment of rights and privileges appertaining to mines or minerals and land is made, the descriptive words 'mining rights' or 'mineral rights' on the assessment roll shall include the right to enter in or upon the land for the exploration, development and production of minerals, including oil, gas, and other hydrocarbons." (§ 607.5.)

It is then, the right to explore, drill for and remove oil and gas that is assessed and taxed. (Atlantic Oil Co. v. County of Los Angeles (1968) 69 Cal.2d. 585,

^{1/} Hereinafter, all unidentified code sections are to the Revenue and Taxation Code.

594-596.)^{2/} It is not the oil and gas in place that is assessed, since the owner of land does not have title to

^{2/} The Supreme Court in Atlantic Oil gave a further exposition on the interest conveyed by oil and gas "leases" and the different approach taken by sections 104 and 607.5 for taxing purposes:

"Under the instruments herein, each public entity granted the privilege of drilling for and producing oil and gas exclusively to a lessee without reservation or exception for the term of the lease. 'The right [to drill for and produce oil] when granted is a profit a prendre, a right to remove a part of the substance of the land. A profit a prendre is an interest in real property in the nature of an incorporeal hereditament. . . . The profit a prendre, whether it is unlimited as to duration or limited to a term of years, is an estate in real property. If it is for a term of years, it is a chattel real, which is nevertheless an estate in real property, although not real property, or real estate. [Citation omitted.] Where it is unlimited in duration, it is a freehold interest, an estate in fee, and real property or real estate.' (Dabney-Johnson Oil Corp. v. Walden (1935) 4 Cal.2d 637, 649. See also Callahan v. Martin, supra, 3 Cal.2d 110, 118; Gerhard v. Stephens, supra, 68 Cal.2d 864, 879-880.) Each lessor retained a reversionary interest, the right to drill for and produce oil and gas after the period specified in the lease. (Dabney-Johnson Oil Corp. v. Walden, supra, 4 Cal.2d 637, 647.) Each lessor also received the right to specified oil and gas royalty payments, a right that we have classified as an incorporeal hereditament, an interest in land. (See Callahan v. Martin, supra, 3 Cal.2d 110, 124; Standard Oil Co. v. J. P. Mills Organization (1935) 3 Cal.2d 128, 134; Dabney-Johnson Oil Corp. v. Walden, supra, 4 Cal.2d 637, 647.)

"It is settled, however, 'that for purposes of taxation the definitions of real property in the revenue and taxation laws of the state control whether they conform to definitions used for other purposes or not.' (Trabue Pittman Corp. v. County of Los Angeles (1946) 29 Cal.2d 385, 393; see also San Diego Trust & Sav. Bank v. County of San Diego (1940) 16 Cal.2d 142, 147.) Section 104 of the Revenue and Taxation Code provides that "Real estate" or "real property"

oil and gas in place (Callahan v. Martin (1935) 3 Cal.2d 110, 117), nor the oil and gas once produced. The assessor must appraise and assess the right to drill for and produce hydrocarbons. (Atlantic Oil Co. v. County of Los Angeles, supra, at 611.)

The usual method of valuing such mining rights interests is to determine the present value of the oil and gas expected to be recovered over the anticipated duration of each agreement and to subtract therefrom the estimated present value of the anticipated cost of withdrawing those substances. (Atlantic Oil Co. v. County of Los Angeles, supra; Ehrman & Flavin, Taxing California Property (2nd ed. 1979) § 20.9.)^{3/} Pursuant to its duty to "[p]repare and issue instructions to assessors designed to promote uniformity throughout the state and its local taxing jurisdictions in the assessment of property for the purposes of taxation" (Gov. Code, § 15606 (e)), the State Board of Equalization has issued and revised, since the adoption of Article XIII A, a rule on valuing oil and gas producing properties. (Cal. Admin. Code, tit. 18, § 468, hereinafter referred to as "Rule 468".)^{4/} As pertinent here, subdivision (b) of Rule 468 sets forth the basic appraisal rule:

"The market value of an oil and gas mineral property interest is determined by estimating the value of the volumes of proved reserves. Proved reserves are those reserves which geological and engineering information indicate with reasonable

2/ (Cont'd)

includes: (a) The possession of, claim to, ownership of, or right to the possession of land. (b) All mines, minerals, and quarries in the land, all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto. . . . Plaintiffs' rights in the public lands are admittedly subject to ad valorem property taxes as 'mining rights' or 'mineral rights' (Rev. & Tax. Code, §§ 201, 104, 607.5), and it is those interests that defendants claim they assessed. . . ." (69 Cal.2d at 594-595; court's footnote omitted.)

3/ The issue in Atlantic Oil was whether the assessors should also deduct the present value of the sums to be paid to the lessor (tax-exempt public agencies) as rent or royalty. The court ruled in the negative as to most of the conveyancing instruments it reviewed.

4/ The entire Rule 468 is set forth in appendix A hereto.

certainty to be recoverable in the future, taking into account reasonably projected physical and economic operating conditions. Present and projected economic conditions shall be determined by reference to all economic factors considered by knowledgeable and informed persons engaged in the operation and buying or selling of such properties, e.g., capitalization rates, product prices and operation expenses."

Subdivision (a), however, in defining the taxable interest contains this:

"The right to remove petroleum and natural gas from the earth is a taxable real property interest. Increases in recoverable amounts of minerals caused by changed physical or economic conditions constitute additions to such a property interest. Reduction in recoverable amounts of minerals caused by production or changes in the expectation of future production capabilities constitute a reduction in the interest. Whether or not physical changes to the system employed in recovering such minerals qualify as new construction shall be determined by reference to Section 463(a)." (Emphasis added.)

Further, the appraisal instructions in subdivision (c), citing as justification "[t]he unique nature of oil and gas property interests requires the application of specialized appraisal techniques designed to satisfy the requirements of Article XIII, section 1, and Article XIII A, section 2, of the California Constitution . . . ", direct that:

"(3) Additions to reserves established in a given year by discovery, construction of improvements, or changes in economic conditions shall be quantified and appraised at market value." (Rule 468(c)(3); emphasis added.)

There could be little doubt that a substantial increase in crude oil prices in the marketplace would, as a matter of appraisal, increase the value of the mining rights being appraised, and Rule 468, in its directive as to reappraising oil and gas interests because of a change in economic conditions, is designed to recognize that fact. The question, however, is whether such annual reassessments run counter to the restrictions of Article XIII A, and we now turn to that section.

In June 1978, by an initiative measure, popularly known as Proposition 13, the people adopted a new Article XIII A to the California Constitution. Section 1 of that article establishes a maximum tax rate that may be

levied against real property in the state. Section 2 radically changes and restricts the assessment procedures for such property, and as amended by Proposition 8 in November 1978 reads:

"SEC. 2. (a) The full cash value means the county assessor's valuation of real property as shown on the 1975-76 tax bill under 'full cash value' or, thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occurred after the 1975 assessment. All real property not already assessed up to the 1975-76 full cash value may be reassessed to reflect that valuation. For purposes of this section, the term 'newly constructed' shall not include real property which is reconstructed after a disaster, as declared by the Governor, where the fair market value of such real property, as reconstructed, is comparable to its fair market value prior to the disaster.

"(b) The full cash value base may reflect from year to year the inflationary rate not to exceed 2 percent for any given year or reduction as shown in the consumer price index or comparable data for the area under taxing jurisdiction, or may be reduced to reflect substantial damage, destruction or other factors causing a decline in value."

The Supreme Court in Amador Valley Joint Union High Sch. Dist. v. State Bd. of Equalization (1978) 22 Cal.3d. 208, dealt with a number of legal attacks on Article XIII A. One of them was a claim that the evaluation method established in section 2 denied certain property owners the equal protection of the law. The court described and upheld this method against that claim as follows:

"By reason of section 2, subdivision (a), of the article, except for property acquired prior to 1975, henceforth all real property will be assessed and taxed at its value at date of acquisition rather than at current value (subject, of course, to the 2 percent maximum annual inflationary increase provided for in subdivision (b)). This 'acquisition value' approach to taxation finds reasonable support in a theory that the annual taxes which a property owner must pay should bear some rational relationship to the original cost of the property, rather than relate to an unforeseen, perhaps unduly inflated, current value. Not only does an acquisition value system enable each property owner to estimate with some assurance his future tax liability, but also the system may operate on a fairer basis than a current value approach. For

example, a taxpayer who acquired his property for \$40,000 in 1975 henceforth will be assessed and taxed on the basis of that cost (assuming it represented the then fair market value). This result is fair and equitable in that his future taxes may be said reasonably to reflect the price he was originally willing and able to pay for his property, rather than an inflated value fixed, after acquisition, in part on the basis of sales to third parties over which sales he can exercise no control. On the other hand, a person who paid \$80,000 for similar property in 1977 is henceforth assessed and taxed at a higher level which reflects, again, the price he was willing and able to pay for that property. Seen in this light, and contrary to petitioners' assumption, section 2 does not unduly discriminate against persons who acquired their property after 1975, for those persons are assessed and taxed in precisely the same manner as those who purchased in 1975, namely, on an acquisition value basis predicated on the owner's free and voluntary acts of purchase. This is an arguably reasonable basis for assessment. (We leave open for future resolution questions regarding the proper application of article XIII A to involuntary changes in ownership or new construction.)

"In addition, the fact that two taxpayers may pay different taxes on substantially identical property is not wholly novel to our general taxation scheme. For example, the computation of a sales tax on two identical items of personalty may vary substantially, depending upon the exact sales price and the availability of a discount. Article XIII A introduces a roughly comparable tax system with respect to real property, whereby the taxes one pays are closely related to the acquisition value of the property.

"In converting from a current value method to an acquisition value system, the framers of article XIII A chose not to 'roll back' assessments any earlier than the 1975-1976 fiscal year. For assessment purposes, persons who acquired property prior to 1975 are deemed to have purchased it during 1975. These persons, however, cannot complain of any unfair tax treatment in view of the substantial tax advantage they will reap from a return of their assessments from current to 1975-1976 valuation levels. Indeed, the adoption of a uniform acquisition value system without some 'cut off' date reasonably might have been considered both administratively unfeasible and incapable of producing adequate tax revenues. The selection of 1975-1976 fiscal year as a base year, although seemingly arbitrary, may be

considered as comparable to utilization of a 'grandfather' clause wherein a particular year is chosen as the effective date of new legislation, in order to prevent inequitable results or to promote some other legitimate purpose. (See Harris v. Alcoholic Bev. Etc. Appeals Bd. (1964) 61 Cal.2d 305, 309-310.) Similar provisions are routinely upheld by the courts. (See, e.g., New Orleans v. Dukes (1976) 427 U.S. 297, 305-306; In re Norwalk Call (1964) 62 Cal.2d 185, 188.)

"Petitioners insist, however, that property of equal current value must be taxed equally, regardless of its original cost. This proposition is demonstrably without legal merit, for our state Constitution itself expressly contemplates the use of 'a value standard other than fair market value' (Art. XIII, § 1, subd. (a).) Moreover, the Legislature is empowered to grant total or partial exemptions from property taxation on behalf of various classes (e.g., veterans, blind or disabled persons, religious, hospital or charitable property; see art. XIII, § 4), despite the fact that similarly situated property may be taxed at its full value. In addition, homeowners receive a partial exemption from taxation (Art. XIII, § 3, subd. (k)) which is unavailable to other property owners. As noted previously, the state has wide discretion to grant such exemptions. (Royster Guano Co. v. Virginia, supra, 253 U.S. 412, 415.)

"Finally, no compelling reason exists for assuming that property lawfully may be taxed only at current values, rather than at some other value, or upon some different basis. As the United States Supreme Court has explained, 'The State is not limited to ad valorem taxation. It may impose different specific taxes upon different trades and professions and may vary the rate of excise upon various products. In levying such taxes, the State is not required to resort to close distinctions or to maintain a precise, scientific uniformity with reference to composition, use or value.' (Ohio Oil Co. v. Conway, supra, 281 U.S. 146, 159.) We cannot say that the acquisition value approach incorporated in article XIII A, by which a property owner's tax liability bears a reasonable relation to his costs of acquisition, is wholly arbitrary or irrational. Accordingly, the measure under scrutiny herein meets the demands of equal protection principles." (Amador Valley Joint Union High Sch. Dist. v. State Bd. of Equalization, supra, at pp. 235-237.)

Thus, the court has upheld this assessment system whereby assessments can only be increased^{5/} (except for the inflation factor permitted by section 2(b)) from the 1975-76 value "when purchased, newly constructed, or a change in ownership has occurred." We do not believe a change of economic conditions qualifies for an increase assessment under section 2(a).^{6/}

As noted above, the taxable interest is the right to drill for and produce hydrocarbons. This interest is created (or "purchased") when the original oil and gas lease is entered into. Under the "acquisition" theory of assessment, as described by the court in Amador Valley, that date or 1975, whichever is later, is the valuation date for that interest unless there is new construction or a change in ownership. The taxable interest may become more valuable due to the increase in crude oil prices, as would a house or an apartment with a general increase in the real estate market as is being witnessed now. Article XIII A does not permit an increased assessment just because of an increase in value. The test is not current value; it is acquisition value, here the value at the time the mining interest was acquired, even if only a fraction of its present value.

Rule 468 attempts to justify its requirement that oil and gas interests be revalued upward because of changed economic conditions on the basis that the increase

^{5/} An adjunct to the issue presented, but which we do not address or express any opinion on, is the question of whether the assessor may reassess downward (1) in the event of a decrease of crude oil prices resulting in a decrease in estimated recoverable oil reserves, or (2) annually to reflect depletion in the reserves from production during the previous year. This question requires an interpretation of the phrase ". . . may be reduced to reflect substantial damage, destruction or other factors causing a decline in value" added to section 2(b) of Article XIII A, and is beyond the scope of this opinion.

^{6/} We do not decide herein, but do note, that new wells drilled as a result of changed economic conditions, namely an increase in crude oil prices, may qualify as new construction, and the argument can be made that such new construction adds value to the taxable property (the mining interest) which reflects the increased and more valuable reserves made available because of the well. This opinion, however, is confined solely to the fact of an increase in estimated recoverable oil reserves resulting from changed economic conditions.

in recoverable amounts of oil and gas thereby caused constitutes an addition to such a property interest. In our judgment, this ignores the nature of the interest being assessed and taxed. The mineral interest is the right to extract as much oil and gas as the operator economically can. Just because the operator now can economically extract more oil and gas (the "new" reserves) does not change his basic mineral rights at all. They are merely more valuable. The operator has no more property interest than he had the day he entered into the lease. No new property has been created.

We conclude therefore that section 2 of Article XIII A prohibits an increase in assessments of oil and gas producing properties solely on the grounds of increase in value because of changing economic conditions.

* * * * *

APPENDIX A

Title 18, California Administrative Code, section 468 reads as follows:

"(a) The right to remove petroleum and natural gas from the earth is a taxable real property interest. Increases in recoverable amounts of minerals caused by changed physical or economic conditions constitute additions to such a property interest. Reduction in recoverable amounts of minerals caused by production or changes in the expectation of future production capabilities constitute a reduction in the interest. Whether or not physical changes to the system employed in recovering such minerals qualify as new construction shall be determined by reference to Section 463(a).

"(b) The market value of an oil and gas mineral property interest is determined by estimating the value of the volumes of proved reserves. Proved reserves are those reserves which geological and engineering information indicate with reasonable certainty to be recoverable in the future, taking into account reasonably projected physical and economic operating conditions. Present and projected economic conditions shall be determined by reference to all economic factors considered by knowledgeable and informed persons engaged in the operation and buying or selling of such properties, e.g., capitalization rates, product prices and operation expenses.

"(c) The unique nature of oil and gas property interests requires the application of specialized appraisal techniques designed to satisfy the requirements of Article XIII, Section 1, and Article XIII A, Section 2, of the California Constitution. To this end, the valuation of such properties and other real property associated therewith shall be pursuant to the following principles and procedures:

"(1) A base year value (market value) of the property shall be estimated as of lien date 1975 in accordance with Section 460.1 or as of the date a change in ownership occurs subsequent to lien date 1975. Newly constructed improvements and additions in reserves shall be valued as of the lien date of the year for which the roll is being prepared. Improvements removed from the site shall be deducted from taxable value. Base year values shall be determined using factual market data such as prices and expenses ordinarily considered by knowledgeable and informed persons engaged in the operation, buying

and selling of oil, gas and other mineral-producing properties and the production therefrom. Once determined, a base year value may be increased no more than two percent per year.

"(2) Base year reserve values must be adjusted annually for the value of depleted reserves caused by production or changes in the expectation of future production.

"(3) Additions to reserves established in a given year by discovery, construction of improvements, or changes in economic conditions shall be quantified and appraised at market value.

"(4) The current year's lien date taxable value of mineral reserves shall be calculated as follows:

"(A) The total unit market value and the volume of reserves using current market data shall be estimated.

"(B) The current value of taxable reserves is determined by segregating the value of wells, casings, and parts thereof, land (other than mineral rights) and improvements from the property unit value by an allocation based on the value of such properties.

"(C) The volume of new reserves shall be determined by subtracting the prior year's reserves, less depletions, from the estimated current total reserves.

"(D) The value of removed reserves shall be calculated by multiplying the volume of the reserves removed in the prior year by the weighted average value, for reserves only, per unit of minerals for all prior base years. The prior year's taxable value of the reserves remaining from prior years shall be found by subtracting the value of removed reserves from the prior year's taxable value.

"(E) The new reserves are valued by multiplying the new volume by the current market value per unit of the total reserves.

"(F) The current taxable value for reserves only is the sum of the value of the prior year's reserves, net of depletions as calculated in (D) above, factored by the appropriate percentage change in the Consumer Price Index (CPI) added to the value of the new reserves, as calculated in (E) above.

"(5) Valuation of land (other than mineral reserves) and improvements.

"(A) A base year value (market value) of land (including wells, casings and parts thereof) and improvements shall be estimated as of lien date 1975 in accordance with Section 460.1, the date of new construction after 1975, or the date a change of ownership occurs subsequent to lien date 1975.

"(B) The value of land (wells, casings and parts thereof) and improvements shall remain at their factored base year value except as provided in (6) below.

"(6) Value declines shall be recognized when the market value of the appraisal unit, i.e., land, improvements and reserves, is less than the current taxable value base of the same unit."